Pepper Hamilton LLP
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COVID-19 Primer for Private Equity Funds

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In a very short period of time, private equity groups and their portfolio companies have had to deal with an unprecedented amount of change in response to the novel coronavirus (COVID-19) crisis. Pepper Hamilton is working diligently in response to these events and has developed and been updating guidance on many of the issues that you may soon face, or indeed may already be facing. The guidance offered below takes into account developments as of today, but, as the situation continues to develop, the guidance will need to evolve as well. Furthermore, your particular facts may or may not easily fall within the guidance discussed below. Your advisers at Pepper Hamilton are available to talk with and help you through these issues as they arise.

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Please also refer to the broader Pepper Hamilton and Troutman Sanders joint COVID-19 Resource Center at https://covid19.pepperlaw.com/ *for additional information in response to the ongoing crisis.*

Health and Employee Matters

It seems inevitable that one of the employees of our firm or one of our portfolio companies will test positive for COVID-19. What do we do? What if the person is still being tested or just exhibiting COVID-19 symptoms?

Do we have to close our offices?

Many or all of our employees are working remotely now. What do we need to be thinking about?

Federal Lending Programs (PPP and Main Street Lending Program)

We have heard about the U.S. Small Business Administration (SBA) emergency loan program for companies that have been impacted by COVID-19. Are we eligible and how do we apply?

There seem to be a number of other federal and state programs available to our portfolio companies. What are they?

We have heard about the Main Street Lending Program. Will my portfolio companies be eligible for financing under this program?

What is the Paycheck Protection Program?

Are our private equity group's portfolio companies eligible for the PPP?

Are any industries ineligible for a PPP loan?

How do I apply for the PPP?

Deal Matters

We have one or more signed purchase or sale agreements; they are in the "executory period." What are the relevant considerations?

Does the COVID-19 crisis and its impact on the stock and other markets constitute a "material adverse effect"?

How is the process of antitrust review of transactions (such as premerger notifications and Hart-Scott-Rodino) being affected by the COVID-19 crisis?

Our transaction is closing soon! Are government offices even open to accept merger or other required charter filings? What other items could be delayed?

Portfolio Company Management and Duties

When there is an emergency situation such as this one, can the directors of our portfolio companies suspend their fiduciary duties? If not, should directors act differently in order to fulfill these duties?

What if there are no particular health issues at our company, but our business operations are nevertheless interrupted? What considerations should we be thinking about?

Financing and Distressed Situations

Our portfolio company's revenues are at risk as a result of the COVID-19 crisis. What can we do to protect our interests and ensure there will still be a company when we come out the other side? Should we wait for our lenders to come to us?

What kinds of EBITDA adjustments might we be able to take in relation to the impacts on the company from COVID-19?

Our portfolio company is having difficulty making payments on its debt and wants to re-structure the instrument. What are the significant tax consequences to the company?

How will state closures affect UCC financing statement filings and related searches?

Can I start using electronic signatures for loan documents?

Financing – Tax Matters

What are the significant tax consequences to the fund of a debt infusion into a portfolio company?

What are the significant tax consequences of an equity infusion into a corporation?

What are the significant tax consequences of an equity infusion into a portfolio company taxed as a partnership?

What are the significant tax consequences if instead of infusing debt or equity into the portfolio company, the fund backstops a loan with an equity commitment or similar credit support?

What are the significant tax consequences to the fund if the fund is a lender in a debt restructuring?

What are the significant tax provisions of the CARES Act in the portfolio company con-text?

Health and Employee Matters

Q: It seems inevitable that one of the employees of our firm or one of our portfolio companies will test positive for COVID-19. What do we do? What if the person is still being tested or just exhibiting COVID-19 symptoms?

A: Obviously, this situation has evolved rapidly and continues to do so. We will make every effort to update this information when appropriate. The information below incorporates current guidance from the Centers for Disease Control and Prevention (CDC), but it is not intended to be a substitute for professional medical advice, diagnosis or treatment. To help you navigate your particular circumstances and the considerations referenced below, as well as assist with certain workplace management issues that may arise, we have prepared Employment FAQs, available at https://www.pepperlaw.com/publications/covid-19-employment-faqs-2020-03-16/.

If an employee comes to work displaying COVID-19 symptoms, stay calm. Immediately separate the employee from other employees and send the employee home. The employee should not return to work until the employee has been fever-free without the use of medication for at least three full days, the employee's other symptoms have improved and either at least seven days have passed since the employee's symptoms first appeared or, if the employee is tested to determine if he or she is still contagious, the employee has received two negative tests in a row, at least 24 hours apart. Employers also should conduct a deep clean of the ill/potentially ill employee's workspace.

If the employee came into close physical contact with other employees during their time in the workplace (i.e., a distance of less than six feet), send those employees home to self-quarantine for 14 days. For employees working in critical infrastructure or other essential businesses (including, but not limited to, workers in food/agriculture, critical manufacturing, information technology, transportation and energy), to ensure continuity of operations, the CDC has advised that these workers may be permitted to continue work following potential exposure, provided they remain asymptomatic and additional precautions are implemented to protect them and the community. Additional precautions include temperature checks, regular monitoring, mask wearing, social distancing and disinfection/cleaning of their workspaces. If any of those employees become ill with COVID-19, those employees should not return to work until they have been fever-free without the use of medication for at least three full days, the employee's other symptoms have improved and

either at least seven days have passed since the employee's symptoms first appeared or, if the employee is tested to determine if he or she is still contagious, the employee has received two negative tests in a row, at least 24 hours apart. Employers also should conduct a deep clean of the ill/potentially ill employee's workspace.

Employers should not reveal the identity of an infected employee unless the infected employee has provided permission to share his or her name (which you can ask, but not require, him or her to provide) because, like with any illness, the reason for an employee's absence is confidential and should not be shared with others. Depending on the nature of your workplace, you want to inform any potentially exposed customers, vendors and/or other building tenants. If you feel it is critical for safety reasons to identify the employee in notifying others or working to determine who may have been exposed, or if the identity will be obvious once the notification is made, please give us a call and we can discuss.

If an employee is being tested for COVID-19 or has already tested positive for COVID-19, report the matter (without identifying the employee) to the applicable local health board. The local agency may have its own protocols to follow, with which you should comply.

Bear in mind as you are going through this situation that — even though you may be trying to help and to ensure the safety of others — employers may not treat people differently based on their age, gender, pregnancy, whether they have an underlying health condition, or any other protected category. If an employee asks to work from home because he or she is in a high-risk category, as defined by the CDC, then the employer may (but is not required to) grant that request. Conversely, an employer may encourage ***or require*** employees to telecommute to control the spread of COVID-19. Many companies have been subject to state shutdown orders requiring businesses that are not essential or life-sustaining businesses to move to a telecommuting environment or otherwise shut down completely. Allowing a sick employee to work remotely in lieu of taking time off may be considered a reasonable accommodation for a disability under the Americans with Disabilities Act (ADA) if the employee can perform the essential functions of his or her job while telecommuting. Note, however, that the ADA does not require employers to lower quality or productivity standards as a reasonable accommodation. Our colleagues at Troutman Sanders have prepared Employer Guidance (available at https://www.troutman.com/insights/employer-guidance-on-sending-workers-home-and-implementing-remote-work-policies-coronavirus-edition.html) if you have determined to send employees home or are implementing remote work policies.

In our Employment FAQs (available at https://www.pepperlaw.com/publications/covid-19-employment-faqs-2020-03-16/), we describe our guidance as to other workplace questions that are becoming more common, including whether an employee is required to wear a face mask; whether the employer may take an employee's temperature at work; obligations to grant time off due to sickness, quarantine orders or childcare needs resulting from COVID-19; and issues relating to short-staffed operations, unemployment benefits, and the possibility of furloughs.

The Occupational Safety and Health Administration (OSHA) has published Guidance on Preparing Workplaces for COVID-19 (available at https://www.osha.gov/Publications/OSHA3990.pdf)for other workplace safety tips. In addition, the Families First Coronavirus Response Act, which became effective on April 1, includes the Emergency Paid Sick Leave Act (EPSLA). Under the EPSLA, employers with *fewer than 500* employees are required to provide 80 hours of paid sick leave to full-time employees (and a prorated number of days to part-time employees) for specified reasons related to COVID-19. Furthermore, the Families First Coronavirus Response Act includes amendments to the Family and Medical Leave Act providing for partial pay for eligible employees who cannot work or telework because they are taking care of dependent children because of school closures or the unavailability of their childcare providers. The implications of this law, particularly given the number of jurisdictions that are facing government-mandated shutdowns, are far-reaching, and we are available to discuss the impacts to your business in this evolving legislative landscape. Additional or different regulations may be introduced in the near future. (Back to the Top)

Q: Do we have to close our offices?

A: The decision of whether to close any given office will depend on several factors, including whether federal, state or local governments have imposed restrictions on that office remaining open, as well as best practices that are independent of regulators. You may have to consider whether your business is "essential," as we have been tracking in "Whether Your Business Is Essential" (available at https://www.pepperlaw.com/publications/is-your-business-essential-guidance-on-difficult-decisions-in-a-time-of-uncertainty-2020-03-21/).

State and local governments have been the most active governmental bodies in mandating that businesses close due to COVID-19 concerns, and their regulations have varied widely. However, common factors in these regulations have been the nature of the busi-

ness; whether the business has been deemed “essential,” “nonessential,” “life-sustaining” or another similar designation; and whether the state or local government’s policies are mandatory or permissive. Regulations on business closures are constantly changing and are sometimes subject to conflicting “clarifications.”

Even where mandatory shutdown regulations are in place, there may be an allowance for skeleton crews to remain on-site to ensure IT functionality for remote access. In addition, many jurisdictions have a process through which businesses can apply for a waiver from closure restrictions to continue to operate on-site.

Regardless of governmental regulation, each management team should also consider whether its business is following best health and safety practices if it decides to remain open for business. That evaluation should include whether it is possible both to maintain best practices in offices and other business spaces regarding social distancing and to keep those spaces clean and sanitary. Although a number of businesses that remain open have made on-site attendance voluntary, companies remaining open (even on a voluntary basis) have a responsibility to follow these best practices. The failure to do so could lead to liability for your company. (Back to the Top)

Q: Many or all of our employees are working remotely now. What do we need to be thinking about?

A: Since COVID-19 has required many companies to function with a remote workforce, there are a number of items to consider moving forward. Above all, an organization should consider whether its current IT infrastructure can allow its business to continue to operate with a completely or predominately remote work force. It should also determine what challenges a surge in employees working remotely will present, including a decrease in IT support staff and an increased dependence on certain information technology and bandwidth.

Steps also need to be taken to ensure that an organization’s data and IT infrastructure is secure. As Troutman Sanders has detailed at https://www.troutman.com/images/content/2/2/v2/224251/Cybersecurity-Tips-to-Prevent-Your-Business-from-Becoming-COVID.pdf, an organization should (1) encourage employee awareness for cybersecurity matters that can arise in remote working environments, (2) implement policies and practices to encourage securing remote work environments, (3) reconsider whether remote access by vendors with access to protected information is appropriate or should be modified, (4) update incident response plans, and (5) review cybersecurity insurance policies. An orga-

nization should also be prepared for an increase in certain cybersecurity attacks, and we have considered ways to reduce cybersecurity attacks (available at https://www.pepperlaw.com/publications/beware-phishing-scams-prey-on-coronavirus-fears-2020-03-18/), recommending training and other methods to combat targeted cybersecurity attacks.

Finally, now that your employees are scattered in ways possibly never contemplated, we recommend considering the extent to which additional business registration, local employment tax or sales and use tax filings may be necessary in additional states. (Back to the Top)

Federal Lending Programs (EIDL, PPP and Main Street Lending Program)

Q: We have heard about the U.S. Small Business Administration (SBA) emergency loan program for companies that have been impacted by COVID-19. Are we eligible and how do we apply?

A: SBA operates a Disaster Loan Program (available at https://www.pepperlaw.com/publications/eligibility-for-sbas-emergency-loan-program-for-businesses-impacted-by-covid-19-2020-03-20/) that provides loans of up to $2 million to eligible small businesses. Congress is considering legislation that would expand the availability of SBA's 7(a) Loan Program. This legislation is in the very early stages, and its provisions remain fluid. We are also tracking other programs and pending federal legislation, but programs and requirements vary widely. We are tracking progress and will provide an update when there is something definitive to report.

With respect to the SBA Disaster Loan Program, to be eligible, the company must:

- be located in a designated disaster area (available at https://disasterloan.sba.gov/ela/Declarations),
- show that it has suffered substantial economic injury as a result of COVID-19, and
- be a "small business."

Substantial Economic Injury

The company must show that it has suffered substantial economic injury as a result of COVID-19. Substantial economic injury means the business is unable to meet its obligations and to pay its ordinary and necessary operating expenses. Economic Injury Disaster Loans provide the necessary working capital to help small businesses survive until normal operations resume after a disaster. Eligibility is also determined if SBA finds that the business is unable to obtain credit elsewhere. If SBA determines that private credit may be available to a business, the business may be deemed ineligible to receive a loan (or the loan amount may be reduced).

Company Must Be a "Small Business"

The company must be a "small business." To be considered a "small business":

- the size of the company alone (**without affiliates**) must not exceed the size standard designated for the industry in which the applicant is primarily engaged, ***and***

- the size of the company **combined with its affiliates** must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is greater.

The size standards for the Disaster Loan Program make reference to the North American Industrial Classification System (NAICS) and are based on either the number of employees (generally 500 to 1,000 for manufacturers) or receipts, depending on the industry.

The concept of "affiliation" is important because the company may lose its "small" status if it is considered to be affiliated with other entities. Concerns and entities are affiliates of each other *when one controls or has the power to control the other, or a third party or parties controls or has the power to control both*. In this context, control is not limited to majority ownership or the ability to appoint directors, as minority investors may be deemed to have control based on contractual consent rights. It does not matter whether control is exercised, so long as the power to control exists. In Pepper's article on April 1 at https://www.pepperlaw.com/publications/sba-affiliation-regulations-impacting-eligibility-for-paycheck-protection-program-7a-loans-2020-04-01/, we described in detail how the affiliation rules may affect you and your portfolio companies and how to approach the process of calculating eligibility.

Companies owned in whole or substantial part by funds licensed by SBA as "small business investment companies" (SBICs) are not considered affiliates of the SBIC. Thus, portfolio companies that may be controlled by an SBIC are not aggregated for purposes of determining whether a company is a small business for purposes of the Disaster Loan Program.

We are available to help you assess whether your portfolio businesses could be considered "small" and, if so, help you through the eligibility and application process (available at https://www.pepperlaw.com/publications/eligibility-for-sbas-emergency-loan-program-for-businesses-impacted-by-covid-19-2020-03-20/). (Back to the Top)

Q: There seem to be a number of other federal and state programs available to our portfolio companies. What are they?

A: At the federal level, there are currently three programs of note. As discussed above, SBA already offers an emergency injury disaster loan program, which may be tapped depending on certain factors given the ongoing COVID-19 conditions.

The federal Coronavirus Aid, Relief, and Economic Security Act (CARES Act), signed into law on March 27, created a new program within the SBA's flagship 7(a) Loan Program called the "Paycheck Protection Program" (PPP). This program's funds were fully allocated as of April 15. However, additional funds are expected to be allocated by Congress to the PPP to reopen the program in the near term.

In addition, on April 9, the Federal Reserve released term sheets for its widely anticipated Main Street Lending Program to ensure credit flows to small and mid-sized businesses in the United States with up to 10,000 employees or no more than $2.5 billion in annual revenue in 2019. The Federal Reserve has not yet opened this program and was soliciting comments through April 16. The released terms are described further below.

In addition, most states and many cities are offering their own programs. If you have questions about specific jurisdictions, please coordinate with us for the most up-to-date options. (Back to the Top)

Q: We have heard about the Main Street Lending Program. Will my portfolio companies be eligible for financing under this program?

A: The Fed released two term sheets on April 8 for a Main Street New Loan Program and a Main Street Expanded Loan Program, which we have separately summarized at https://www.pepperlaw.com/publications/federal-reserve-releases-details-of-main-street-lending-program-2020-04-13/. The proposals were open for comment until April 16, and there are significant questions that will need to be addressed before loans can be issued under the Main Street programs. Pepper Hamilton and Troutman Sanders commented on April 17, 2020 (available at https://www.troutman.com/insights/comments-to-federal-reserve-main-street-lending-program.html).

Under both programs, loans would be made by banks and a special purpose vehicle established by the Fed would purchase a 95 percent participation in the loans. Loans under the New Loan Program would be unsecured. Loans under the Expanded Loan Program must be an upsized tranche of an existing term loan made by a bank, and would share in the collateral securing that existing term loan. Based on this structure, we expect that lending banks will need to fully underwrite loans originated under the programs and that loan documentation will include full representations and covenants comparable to other bank term loans.

Crucially, as currently proposed, both the New Loan Program and the Expanded Loan Program have maximum leverage ratios that may make many PE-backed companies ineligible — 4x EBITDA for the New Loan Program and 6x EBITDA for the Expanded Loan Program. In addition, participation in the programs will result in limitations on dividends and compensation that may be unappealing to many PE groups. (Back to the Top)

Q: What is the Paycheck Protection Program?

A: The CARES Act created a new program within the SBA's flagship 7(a) Loan Program called the "Paycheck Protection Program" (PPP). Under the PPP, SBA will guarantee 100 percent of the amounts loaned by participating lenders to certain U.S. small businesses, nonprofit organizations, veterans organizations and tribal businesses. The legislation authorizes $349 billion for commitments for the PPP. Eligible participants are permitted to borrow up to $10 million under the PPP for a covered period from February 15, 2020 through June 30, 2020.

A key feature of the PPP is that loans made under the PPP may be forgiven as long as the loan proceeds are used for proper purposes, including payroll costs (as defined by the CARES Act), rent/utilities, and certain mortgage payments.

For more information on the PPP, including how you determine the amount of the loan available and forgivable to eligible businesses, see our March 27 summary of the PPP at https://www.pepperlaw.com/publications/overview-of-coronavirus-aid-relief-and-economic-security-act-cares-act-paycheck-protection-program-2020-03-27/ and our April 3 update advising on interim final rules issued by SBA at https://www.pepperlaw.com/publications/paycheck-protection-program-new-loan-application-interim-final-rule-released-on-eve-of-program-opening-2020-04-03/. (Back to the Top)

Q: Are our private equity group's portfolio companies eligible for the PPP?

A: It depends. While private equity sponsorship does not disqualify a portfolio company, SBA's affiliation rules may make it difficult for a private equity-sponsored company to meet the definition of a small business concern.

In general, all "small business concerns" may apply for a PPP loan. A business is a "small business concern" if either:

- (a) the size of the concern alone (without affiliates) does not exceed the size standard designated for the industry in which the applicant is primarily engaged, ***and*** (b) the size of the concern combined with its affiliates is not greater than the size standard designated for either the primary industry of the concern alone or the primary industry of the concern and its affiliates, whichever is greater; ***or***

- (a) the business (together with its affiliates) has a maximum tangible net worth that is not more than $15 million, ***and*** (b) has an average net income after federal income taxes (excluding any carryover losses) for the previous two full fiscal years that is not more than $5 million. [*See our April 4 article describing this "alternative test" at* https://www.pepperlaw.com/publications/paycheck-protection-program-are-you-feeling-small-and-left-out-there-may-be-an-answer-for-you-2020-04-05/]

Additionally, any business concern is eligible for a PPP loan if the business concern (with its affiliates) has no more than 500 employees. Affiliates of a business will include other entities that, generally speaking, share common control or common management. The

portfolio companies of most mature private equity firms will have difficulty satisfying the size tests described above due to these affiliation rules (which are SBA rules, not new to the PPP) because employees of unrelated portfolio companies may be added together for purposes of determining eligibility for the PPP. For this purpose, contractual consent rights may be deemed to create a control relationship, so this could also apply to minority investors. In Pepper's article on April 1 (available at https://www.pepperlaw.com/publications/sba-affiliation-regulations-impacting-eligibility-for-paycheck-protection-program-7a-loans-2020-04-01/), we described in detail how the affiliation rules may affect you and your portfolio companies and how to approach the process of calculating eligibility. The employees of any affiliates will be counted towards the 500-employee count, except with respect to the following:

- any business concern with no more than 500 employees that, as of the date on which the PPP loan is disbursed, is assigned a NAICS code beginning with 72 (Accommodation and Food Services);
- any business concern operating as a franchise that is assigned a franchise identifier code by SBA; or
- any business concern that receives financial assistance from a company licensed by SBA as a "small business investment company" (SBIC).

We are available to help you assess whether your portfolio businesses could be eligible for a PPP loan. (Back to the Top)

Q: Are any industries ineligible for a PPP loan?

A: SBA's interim final rule clarified that businesses that are not eligible for PPP loans are identified in 13 C.F.R. 120.110 and described further in SBA's Standard Operating Procedure (SOP) 50 10, Subpart B, Chapter 2, except that nonprofit organizations authorized under the CARES Act are eligible. Businesses not eligible for a PPP loan include financial businesses primarily engaged in the business of lending (such as banks, finance companies and factors); life insurance companies; businesses deriving more than one-third of gross annual revenues from legal gambling activities; and private clubs or businesses that limit the number of memberships for reasons other than capacity. (Back to the Top)

Q: How do I apply for the PPP?

A: You will have to submit a loan application with a participating lender. Most SBA lenders are expected to participate, and additional lenders can join the program. You should only refer to the PPP loan application linked on the U.S. Treasury website or as provided by your bank, as updates to the form may not be widely disseminated. The participating lender may also require you to complete its loan application.

The PPP loan application process was set to open on April 3, but many lenders did not begin to accept applications until April 6 (or later). Nonetheless, we suggest you determine your portfolio company's eligibility promptly and complete an application as the loans are on a "first-come, first-served" basis. (Back to the Top)

Deal Matters

Q: We have one or more signed purchase or sale agreements; they are in the "executory period." What are the relevant considerations?

A: The first consideration many clients are interested in is whether or not this crisis can be considered a "material adverse effect." This is the subject matter of the next Q&A below. Other executory period considerations include:

- *"Ordinary Course" Covenants*. Virtually all purchase agreements contain provisions that require the seller to operate the business being sold in the "ordinary course" between signing and closing in order to ensure that the business to be acquired is preserved and not adversely altered by the actions of the seller. Because the language of these covenants is not standardized and can vary from purchase agreement to purchase agreement, careful attention must be paid to the specific requirements of the relevant language in your purchase agreement. Although force majeure clauses are more common in supply agreements than they are in purchase and sale contracts, to the extent your purchase agreement contains such a clause, we have specifically analyzed (available at https://www.pepperlaw.com/publications/your-contracts-in-a-coronavirus-world-2020-03-16/) whether these clauses may provide a party relief for failing to perform pre-closing covenants.

Sometimes, the "ordinary course" covenant is also accompanied by a specific list of prohibited acts for which a seller must obtain buyer's consent before undertaking. Ex-

traordinary situations (such as the COVID-19 crisis) do not relieve sellers of this obligation. As such, sellers should follow the requirements of the purchase agreement and seek the consent of a buyer when required (and any such consent should be memorialized in writing). Buyers should keep in mind that there is often a common law obligation to act reasonably and in good faith unless that standard is modified by the purchase agreement. If the buyer refuses to grant a requested consent, sellers should consult counsel in order to analyze the specific situation before any further action is taken.

It is important for officers and directors also to be mindful that they must continue to comply with their fiduciary duties, and that compliance with those duties may dictate a course of action that would conflict with the company's contractual obligations. For example, assume that the "ordinary course" covenant in a purchase agreement prohibits the incurrence of debt without the buyer's consent. During this crisis, it may be necessary to incur additional debt in order to maintain adequate cash. Even if the buyer's consent to this incurrence cannot be obtained, the board's fiduciary duties may, depending on the circumstances, require such incurrence.

In these difficult circumstances, where the specific facts of the situation and language of the agreement need to be carefully evaluated, consultation with legal advisers can be critically important.

- *Conditions to Closing*. A buyer unsure about consummating a transaction on the currently negotiated terms should consider the buyer's conditions to closing. Typically, these conditions include, among others, certain pre-closing covenants that the seller or target must perform, as well as a full "bring down" of their representations and warranties. If the seller and target cannot fulfill the pre-closing covenants and bring down their representations and warranties to the required standard for closing, the buyer typically can "walk" from the transaction. Note, however, that most purchase agreements will have outside dates that restrict *when* a party can walk away or terminate.

- *Third-Party Consents*. Purchase agreements often require that the seller and/or the buyer obtain the consent of certain third parties as conditions to closing. In addition to any antitrust or other governmental consents, this often includes consents of customers or suppliers under the seller's material contracts. Given the likelihood that these third parties are working remotely and similarly dealing with interruptions to their business, the turnaround time for obtaining such consents will likely be longer. Buyers and sellers should coordinate closely on the best way to connect with third parties

and allow for ample lead time to obtain consents. For deals that are not yet signed, parties should take this into account when determining the outside date.

- *Updates to Schedules*. Another critical provision to examine regards the ability of the seller to update disclosure schedules before closing, and what the effect of these updates (if permitted) will be. If the seller has the ability to update schedules, it increases the likelihood that the seller's representations will be accurate at closing and thus the buyer's conditions to closing will be met. However, in some cases, even though the seller can update schedules and force the buyer to close, the seller will still be responsible for pre-closing breaches under the indemnity provisions as if the updates never happened. (Back to the Top)

Q: Does the COVID-19 crisis and its impact on the stock and other markets constitute a "material adverse effect"?

A: Although the answer to this question depends largely on the language of the "material adverse effect" definition within the purchase agreement, it is unlikely under Delaware law that the COVID-19 outbreak (or its collateral impact on markets) would constitute a material adverse effect under typical formulations of that definition. Common definitions of "material adverse effect" often exclude (1) economy-wide or market-wide changes, (2) pandemics or infectious diseases, and (3) catastrophic force majeure events, which all have the effect of shifting the general market risk to the buyer during an executory period.

That said, under the typical definition, a material adverse effect may still occur if the target is disproportionately impacted by those events as compared to similarly situated participants in the target's industry, shifting the *specific* market risks back to the target. In other words, under typical definitions, in order for a target to suffer a material adverse effect, COVID-19 would need to disproportionately affect a particular target's business as compared to other industry participants. This disproportionate impact is unusual at best, and, even if arguably occurring, there remains a high burden on a buyer to prove the disproportionate impact, given the widespread and systemic impacts that COVID-19 is having on the economy in general.

Notwithstanding the foregoing, under Delaware law, a material adverse effect will be found to have occurred only when the target suffers a financially adverse impact that is both (1) material and (2) durationally significant. With respect to *materiality*, Delaware

courts will compare EBITDA generated by the target in the quarters following the event that caused the purported material adverse effect with the EBITDA generated by the target in the corresponding reporting period. Given the negative economic impact COVID-19 has had on the financial performance of companies across the world, it is certainly possible that a target's negative financial performance could meet the materiality threshold under Delaware law. However, more is required to constitute a material adverse effect; the financially adverse impact must also substantially threaten the overall earnings potential of the target in a *durationally significant* manner. A "short-term hiccup" in EBITDA will not suffice. Rather, the financially adverse impact must be expected to last, at a minimum, more than a year. The lack of clarity with respect to how long the COVID-19 pandemic will last, and consequently how its effects will be felt on a target and its business, means that the standard for durational significance is, at best, unclear at this time.

For more detailed analysis, see Troutman Sanders on COVID-19 at https://www.troutman.com/insights/material-adverse-effects-in-the-onslaught-of-the-coronavirus.html and our views on current Delaware law on the issue at https://www.pepperlaw.com/publications/delaware-court-of-chancery-issues-unprecedented-material-adverse-effect-ruling-2018-10-03/. (Back to the Top)

Q: How is the process of antitrust review of transactions (such as premerger notifications and Hart-Scott-Rodino) being affected by the COVID-19 crisis?

A: Although the competition enforcement agencies continue to operate, the process is certainly slowing down. Although the U.S. Federal Trade Commission and the U.S. Department of Justice have reinstated their process for granting early termination of the HSR waiting period, they are also requesting (through their "pull and refile" procedure and timing agreements) that the parties agree to extensions. The guidance from the agencies makes clear that deals will likely take longer to get through the premerger notification process and the parties should consider more in-depth prefiling planning and analysis. Premerger filings must be made electronically, but hard copy documentation will be necessary after the resumption of normal agency operations. Consider adjusting risk allocation and premerger notification coordination obligations in your purchase agreement to take into account the likely delay, including possibly extending relevant "outside dates." Also consider the type of material that is being prepared and delivered, given the likely remote work situations in which even reviewers will find themselves. We have analyzed Potential Considerations (available at https://www.pepperlaw.com/publications/

covid-19-hits-global-merger-antitrust-enforcement-potential-considerations-2020-03-23/) and more detailed strategies with our colleagues at Troutman Sanders, including considerations with respect to certain non-U.S. agencies. (Back to the Top)

Q: Our transaction is closing soon! Are government offices even open to accept merger or other required charter filings? What other items could be delayed?

A: The normal mechanics of closing any transaction or financing requiring the filing of documents with a governmental authority must be reevaluated as a result of the COVID-19 pandemic. In response to this crisis, the secretary of state and local county offices in many states have reduced or suspended the availability of their in-person counter service, and many other services these offices provide are also experiencing delays or have been cut off entirely due to reduced personnel. In a deal process, the services provided by the secretary of state are often utilized in multiple ways, including:

- the formation of an acquisition vehicle used to serve as the purchasing entity in a transaction

- the filing of certificates of merger, articles of dissolution, certificates of conversion and other documents required to complete a merger, F reorganization or other changes in corporate form and existence

- obtaining certified charters, certificates of good standing and qualifications to do business

- the filing of amendments to an entity's charter or certificate of formation.

In addition, local county offices are often needed to transfer title to real estate, release county-level UCC lien filings, and confirm payment of property taxes.

Fortunately, the services outlined above are offered online in many states, with varying response times for receiving the required service or document. For example, as of this writing, the Delaware Secretary of State is running business as usual for online filings and 24-hour turnaround times for certain services remain available. In Pennsylvania, although the Secretary of State offices are closed, services are available online; however, expedited service is not available and there is an extended delay in the receipt of evi-

dence of filing. Illinois has closed all Secretary of State offices and has very limited online filing options — for example, certificates of merger cannot be filed online in Illinois and therefore cannot be filed until the offices reopen, which would prevent a merger transaction involving Illinois entities from closing until the offices reopen.

In sum, secretary of state office closures and service delays could cause delays in your transaction. Our service provider agents are tracking the current secretary of state office closures and other restrictions at http://ct.wolterskluwer.com/covid-19-coronavirus, and we are monitoring for additional measures as well. Although the list is frequently updated, the information is constantly changing and available services vary greatly from state to state, so each applicable state should be checked in real time and confirmed. (Back to the Top)

Portfolio Company Management and Duties

Q: When there is an emergency situation such as this one, can the directors of our portfolio companies suspend their fiduciary duties? If not, should directors act differently in order to fulfill these duties?

A: There is no exception during times of crisis to a corporate director's obligation to observe fiduciary duties. This applies to other entities as well, including managers of LLCs, general partners of partnerships, and trustees of trusts. (Note that some state laws, such as Delaware, permit the elimination of certain of a manager's fiduciary duties to a Delaware LLC if so specified in the company's operating agreement. This is a broader elimination of these duties that is not crisis-dependent and not at issue here). As such, director decisions need to continue to reflect the director's good faith determination of what is in the best interest of the business. The answer to what is in the best interest of the business may be different in times of crisis, or it may be appropriate to "stay the course."

If there is reason to believe that the company is insolvent (or if the company expects not to be able to pay debts that are reasonably foreseeable), directors should exercise particular caution. They can be held personally liable for shareholder distributions made by an insolvent company, and some states allow creditors to bring these claims directly. Creditors may also be able to bring claims to void transactions and claw back transfers. The key to protecting the private equity fund is for its nominees on portfolio company boards to (1) act in good faith, (2) be consistent in how issues are approached, (3) make decisions based on as much information as possible, and (4) document the rationale for

decisions. One of the board's primary responsibilities is overseeing management. Board members may want to consider increased frequency of board calls, or the designation of a special committee to address COVID-19 related matters, in order to hear from and provide direction to management to address rapidly changing circumstances. In times of crisis, the best protection against second-guessing with the benefit of hindsight is fulsome documentation in real time.

The current environment has created a number of newly distressed situations. If you find yourself working with a newly distressed company due to COVID-19, please review our article on navigating insolvency risk in newly distressed companies and the associated fiduciary duties at https://www.pepperlaw.com/publications/director-fiduciary-duties-navigating-insolvency-risk-in-newly-covid-19-distressed-companies-2020-04-17/. (Back to the Top)

Q: What if there are no particular health issues at our company, but our business operations are nevertheless interrupted? What considerations should we be thinking about?

A: First, use this time to finalize any protocols and procedures should an actual direct health situation arise. In addition, use this time to review your material contracts and consider whether the company will be able to continue performance thereunder, or if it will only be able to do so in a diminished capacity. Consider the ability of the company's counterparties to do the same. If you have a good relationship with the relevant business partner, consider if it is possible to negotiate revisions to the performance obligations to adjust to the practical reality. And further, consider the practical business interests of generally keeping customers and suppliers informed. To the extent that the company has to rely on the terms of an applicable contract, many of the force majeure provisions of contracts are being carefully scrutinized to determine if the COVID-19 crisis constitutes a basis for not being able to perform a contract, as we have discussed more broadly in an analysis of Force Majeure Clauses at https://www.pepperlaw.com/publications/your-contracts-in-a-coronavirus-world-2020-03-16/.

Additionally, companies should ensure that they have a business continuity strategy in place in the event one or more of your key employees becomes sick or otherwise incapacitated. Given the contagious nature of the virus, succession planning should take into account the possibility that multiple members of your executive team are unable to func-

tion in a normal capacity for an extended duration. At the fund level, you should revisit any key-man provisions in your fund documents and be prepared with a plan to take to your limited partners if such a provision is triggered. (Back to the Top)

Financing and Distressed Situations

Q: Our portfolio company's revenues are at risk as a result of the COVID-19 crisis. What can we do to protect our interests and ensure there will still be a company when we come out the other side? Should we wait for our lenders to come to us?

A: While there is no "one size fits all" advice in this type of situation, generally speaking, the first step is to take a hard look at the 13-week cash flow under the "new reality" scenario. Strip out every cost that is not absolutely essential or that can be reduced or deferred, including capital expenditures, vendors, rent and payroll. Seriously consider drawing down on any availability under your existing lines of credit. Even if such a draw down provides the company with adequate cash for an interim period, this is also the time to consider reaching out to lenders to restructure the company's debt, even if only temporarily. Consider our more detailed thoughts on Restructuring in the Time of Coronavirus (available at https://www.pepperlaw.com/publications/restructuring-in-the-time-of-coronavirus-2020-03-20/), and consider changes to the company's borrowing base, reduction of interest, partial loan forgiveness, PIKing interest payments, establishing a temporary moratorium with deferred payments tacked on to the end of the loan, or splitting the existing debt into a senior/subordinated note structure. We expect that most lenders will be willing to work with borrowers that are proactive in seeking out short-term solutions, although they may be less willing to fund losses, particularly given the widespread breadth of the economic and health issues.

Should the company need to go down this path, the Bankruptcy Code gives a debtor breathing room from creditors under the automatic stay, and allows the debtor to confirm a plan of reorganization over the objections of nonconsenting creditors. Under some circumstances, existing equity holders are able to retain ownership of the debtor company even after bankruptcy, but forward-looking planning is critical. (Back to the Top)

Q: What kinds of EBITDA adjustments might we be able to take in relation to the impacts on the company from COVID-19?

A: The specific wording in the company's loan agreements must be reviewed as the language of each such agreement is specific to the bank and borrower. Most EBITDA

adjustments tie to specific items of gain or loss flowing through a company's income statement, such as unusual or nonrecurring "losses" or "charges." In many cases, there may be clauses that would allow add-backs for costs incurred to respond to the crisis — such as costs or charges related to office closings, to re-route or replace supply chains, or to implement work-at-home solutions. However, most EBITDA definitions do not readily provide any adjustments for the failure of revenue to come in the door, as will likely be the impact of COVID-19 for many businesses. As a result, we expect many borrowers will need to seek relief from their bank for noncompliance with their financial covenants. Even businesses with only "covenant lite" agreements may need to seek relief in order to pursue business initiatives conditioned on meeting certain financial metrics. (Back to the Top)

Q: Our portfolio company is having difficulty making payments on its debt and wants to restructure the instrument. What are the significant tax consequences to the company?

A: If the restructured debt constitutes a "significant modification" of the original debt for tax purposes (whether or not there is an actual exchange of debt instruments), the transaction is considered an exchange for tax purposes. Significant modifications can arise, for example, if there are certain changes in yield, principal amount, payment timing, obligor or security. Sometimes, the modifications can be so significant that what was debt is now considered as equity for U.S. tax purposes.

When the modification of the debt is a significant modification, it is possible that the borrower can have cancellation of debt income. If, however, (1) the debt is not publicly traded (which is a broad term), (2) the issue price of the old note is the same as the new note, and (3) each note provided for interest of at least the applicable federal rate, then there may not be any current impact. If the modifications include other components, such as the granting of warrants, a more technical analysis is needed.

A corporate debtor may offset its income, including cancellation of debt income, with prior years' net operating losses (NOLs) to the extent the NOLs are not subject to limitation on use. A corporate debtor may exclude cancellation of debt income to the extent of insolvency or in its entirety in a federal bankruptcy case. To the extent cancellation of debt income is excluded under these circumstances, tax attributes of the corporation are reduced.

If the portfolio company is a tax partnership, the insolvency and bankruptcy cancellation of debt exclusions, as well as the related attribute reduction, are determined at the partner level (*e.g.*, insolvency is present to the extent the relevant partner is insolvent).

Of note, a common fact pattern involves a party related to the portfolio company for tax purposes, such as the fund, acquiring the debt at a discount. In this case, the tax rules may result in cancellation of debt income to the debtor, with the debt deemed reissued to the fund with original issue discount. (Back to the Top)

Q: How will state closures affect UCC financing statement filings and related searches?

A: In states where the ability to file UCC financing statements can be done online, the ability to file will remain unaffected. In states without online service, counter service has been widely suspended, so physical filing and retrieval of copies of UCC financing statements in those offices will be delayed until they reopen. Some secretary of state offices have set up drop boxes for physical filings, but it is unclear whether or to what extent these alternate filing measures will continue.

In all states, there is the ability to search for UCC financing statements online, so we do not expect that obtaining state-level UCC lien search results will be affected. Some counties have made their filings available online, so these should be checked on a case-by-case basis, especially if there are fixtures in the collateral package or specialty collateral that require filing against the collateral at the county level. (Back to the Top)

Q: Can I start using electronic signatures for loan documents?

A: In most states (including, but not limited to, California, New York, Pennsylvania and Delaware) and the District of Columbia, electronic signatures have the same legal effect as manual signatures. Under federal law, an electronic signature can be any electronic sound, symbol or process that is attached to or logically associated with a contract or record, and executed or adopted with the intent to sign the record. If a law requires a signature, an electronic signature satisfies the law. However, these laws do not apply to certain commercial transactions. Negotiable instruments, such as negotiable promissory notes, mortgages and other instruments of title where possession of the instrument confers title, remain agreements that should not be signed electronically. Even if you come across a lender that has relaxed its standards for electronic signatures, you may need to ensure

that you are not tripped up by local laws requiring express authority for how a document is signed (which would be covered in applicable authorizing board resolutions). For credit agreements, many lenders have historically continued to require ink-signed copies of signature pages. In this environment, however, lenders may start to permit electronic signatures on a case-by-case basis, but it is important to reconfirm a lender's requirements directly and early in your process. (Back to the Top)

Financing - Tax Matters

Q: What are the significant tax consequences to the fund of a debt infusion into a portfolio company?

A: Assuming the company is a corporation for tax purposes, the most significant issue in such a case is the possibility of dry income — taxable income before cash is received. Dry income can arise if the interest yield is greater than the interest to be paid annually. This often happens where there is PIK interest in the loan or the loan is issued with an equity kicker like a warrant (the value of the warrant generally will reduce the issue price of the note, so there is additional interest in the note).

If the portfolio company is taxed as a partnership for U.S. tax purposes, there can be the following additional considerations: (1) if the loan goes bad, there will be cancellation of debt income in the portfolio company (treated as ordinary income) that is allocated up to the fund; (2) the fund takes a write-off on the loan, but the write-off is a capital loss, which cannot be used to offset the ordinary cancellation of debt income; and (3) advances to portfolio companies that are partnerships for U.S. tax purposes may be better off made in preferred equity. (Back to the Top)

Q: What are the significant tax consequences of an equity infusion into a corporation?

A: If a fund invests in preferred stock of a corporation, there is some uncertainty as to whether accrued but unpaid dividends on the stock may be includible in income of the fund over time to the extent the corporation has earnings and profits. This will not be the case, however, if the company has the right to declare the dividend at any time that its board of directors decides, or if the preferred stock participates with the common stock in dividends and liquidating proceeds in a meaningful manner (i.e., the stock is "participating preferred") or is not puttable, callable or redeemable (*i.e.*, the stock is "evergreen").

Further, if the fund invests in stock (or, in certain cases, equity derivatives or convertible debt) and the investment causes an "ownership change" in the corporation (generally, a greater-than-50 percent change in ownership based on stock value over the three years preceding the investment), NOLs of the corporation may be limited in use to offset future income. An ownership change analysis (under Internal Revenue Code section 382) should be considered in conjunction with any corporate equity infusion. (Back to the Top)

Q: What are the significant tax consequences of an equity infusion into a portfolio company taxed as a partnership?

A: If the portfolio company is a partnership (including an LLC taxed as a partnership), the fund would need to consider the implications that (1) foreign partners of the fund will have U.S. taxable income (ECI) with respect to the portfolio company's operations to the extent that income is considered "effectively connected" with a U.S. trade or business and (2) tax-exempt partners of the fund will have unrelated business taxable income, or UBTI, with respect to the portfolio company's operations. Further, if the equity investment is an investment with a preferred return (*e.g.*, an accruing percentage interest or multiple of original investment), depending on the waterfall and tax allocation provisions of the portfolio company operating agreement, the fund may be considered to have income without cash to the extent the preferred return is unsupported by allocated income (*e.g.*, if the company is flat or earning little money to support the preferred return). (Back to the Top)

Q: What are the significant tax consequences if instead of infusing debt or equity into the portfolio company, the fund backstops a loan with an equity commitment or similar credit support?

A: The most significant issue in this context is structuring the equity backstop to avoid having the debt treated for tax purposes as an obligation of the fund (*i.e.*, the creditor should be looking to the company and not the fund for payment based on the circumstances). If the debt were treated as a fund obligation, the debt might be considered "acquisition indebtedness" under the broad construct of the UBTI rules and tax-exempt investors in the fund could become subject to tax on income generated from the portfolio company investment. (Back to the Top)

Q: What are the significant tax consequences to the fund if the fund is a lender in a debt restructuring?

A: From the lender's perspective, if a debt restructuring results in a taxable exchange, the lender realizes gain or loss. The installment sale rules may apply if gain is realized. If the restructuring is treated as a tax-free recapitalization, gain is generally deferred, subject to certain limitations (*e.g.*, to the extent cash is received). In the context of a corporate debtor, the determination of whether an exchange (or deemed exchange) of an original debt instrument for a new debt instrument is a recapitalization turns on whether the debt instruments at issue constitute securities for tax purposes (generally, debt instruments with at least a five-year term). (Back to the Top)

Q: What are the significant tax provisions of the CARES Act in the portfolio company context?

A: The CARES Act permits net operating losses (NOLs) incurred in 2018, 2019 and 2020 to be carried back five years. Under prior law, since 2018, losses could only be carried forward, not carried back. The five-year carryback period could provide additional tax benefits for taxpayers with capacity to carry back losses to 2017 (or a prior year), as these losses would reduce taxable income that was generally taxed at a 35 percent corporate tax rate (rather than the current 21 percent corporate tax rate). Further, the 80 percent annual taxable income limitation on the use of NOLs no longer applies for tax years beginning before January 1, 2021 (*i.e.*, available NOLs can be used to offset 100 percent of taxable income, assuming the NOLs are not otherwise limited in use by changes in ownership, etc.).

In addition, the CARES Act increased the "adjusted taxable income" (ATI) limit for interest deductions. Prior to the CARES Act, if a business met a threshold of more than $25 million in revenue, interest deductions were limited to the taxpayer's business interest income plus 30 percent of the taxpayer's ATI. The CARES Act changes the ATI limit to 50 percent for corporations for 2019 and 2020. The ability to take greater interest deductions may increase a corporation's NOL available for carryback.

The parties to a portfolio company acquisition need to consider which party should get the benefits of any NOLs and corresponding refunds. Parties should also consider who controls the preparation of relevant income tax returns and management of relevant income tax audits. Further, acquisition documents for transactions closed in 2018, 2019

and 2020 (prior to the CARES Act) should be reviewed to understand the impact of the CARES Act on which party might get the benefit of NOLs. (Back to the Top)